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Hugh Moir
Group Head of Operations & Information Technology, F&C Investments and Thames River Capital
The Malta Financial services Authority (MFSA) is the single licensing and supervisory authority for all financial services activity. The Authority is an autonomous public institution set up by law. The sector overseen by MFSA includes banks, investment firms, insurance companies and financial intermediaries who provide a wide range of products and services on the domestic and internal markets. The regulation of the Malta Stock Exchange also falls under the responsibility of the MFSA.

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Clear Path Analysis is a media company that specialises in the publishing of high quality, online reports and events in the financial services and investments sector.
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Hassan Machmouchi: In your experience what aspects of front office operations would present the greatest hindrance to fund managers?

Hugh Moir: In my experience, the most prevalent is the multiplicity and complexity of the systems architecture and application footprint that fund managers and dealing desks work within.

From an F&C perspective, we have undertaken a considerable degree of work over the last couple of years to address this particular issue. We have consolidated multiple order management systems and modernised the desktop resulting in a significant drop in technical complexity, consistency in data delivery and a reduction in operating risk.

Hassan: In effect it is trying to consolidate the legacy systems that you have had as well as ensuring that everything is fully compliant and transparent across the group?

Hugh: In our case it has been significant. We were finding (based on F&C as an independent investment manager so prior to our recent acquisition by the Bank of Montreal) that we were diverting significant amounts of investment spend to support, maintain and develop the investment book of record system to support increasingly complex processing. This, together with the impact of new regulatory requirements meant that spending on the core processing infrastructure was actually consuming a higher proportion of budget to the detriment of the Front Office infrastructure and decision support systems.

Hassan: Have you found that, by working with State Street, these issues have naturally become less complex for you because you simply don’t have to worry about them? Has this had a beneficial impact on the business itself i.e. has it allowed your managers to more effectively perform their core jobs?

Hugh: Yes, but I would say much is still a work in progress. The immediate benefit of the outsource was that we were able to fundamentally reshape our organisational structure and technical infrastructure. We reduced headcount and redesigned how we supported the business. In addition, we consolidated our data centre footprint moving from four data centres to two giving us a modern infrastructure with a considerable degree of flexibility to adapt to changes in the business cycle.

On the application side we were able to redirect much of that investment spend as well as address legacy complexity and an aging desktop operating system. By mid-July (2014) we will have completed the migration from five order management systems to one single system, thinkFolio, providing significant benefits, on numerous levels, not just to the front office but also to many of the control functions for example, mandate compliance and operational risk. This simplification makes evolving our data strategy and data utilisation easier as, operating from a single system, your ability to consume and manipulate data is significantly advantaged.

Hassan: Have you found that this has added to the natural ability to create new products?

Hugh: I wouldn’t say that it is directly correlated to the creation of new products but what it does do is enable us to adapt and implement much faster to new product ideas and new instruments. Previously, we would have had a significantly more complex technical environment to work within.

Hassan: How can fund managers be comfortable with outsourcing key elements of their operations whilst maintaining their competitive advantage?

Hugh: This is very much about the outsourcer partner that you choose and the suitability of their platform to support not just your current business activity but your future business needs and trajectory. We spent a considerable period of time and effort in due diligence that ensured that we selected an operations outsourcing partner that
Liberating the front office – designing outsourcing programmes to increase front office efficiency

met F&C’s requirements. This was fundamental to ensuring that what we ended up with was a successful outsource and ongoing operating model that is efficient and suitable to support the future state of our investment management activity.

Hassan: It is then about future planning and having a good core idea of where you want to take the business, then finding the right partners who will help you achieve those goals?

Hugh: Very much so. Working with partners who understand your business and objectives, defining detailed service level agreements and being able to influence their priorities is key to the benefits you can enjoy as a client. However, what works for one firm may not work for another. What is important is the ability to look at your operations environment and question whether today’s setup is suitable for tomorrow. In our case, we decided that we needed to move away from core processing to an outsource provider that could deliver a more efficient service. That said, what is vital is how you manage change and influence priorities. To assist in this we created a user group to optimise services collectively.

Hassan: Can you give an example of your own outsourcing initiatives, and more specifically how these have increased efficiency?

Hugh: We’ve seen a considerable improvement in the timeliness and processing of our transaction activity and in data delivery for start of day files. We’ve also enjoyed a significant improvement in various key performance indicators (KPI’s) like reconciliation break resolution and posting accuracy. Overall we’ve seen a general improvement in data quality and operating efficiency that has improved data reliability ensuring our start of day files are timely and give portfolio management confidence that front office systems are complete and accurately populated. This has also been helped by the consolidation of our order management systems to a single application.

Hassan: Would you say that because of the added efficiency in the front office that this has also had a positive impact on your other operations with the middle and back offices?

Hugh: Yes it has, we see improvement across the board and, although it is not perfect, we are operating more effectively and efficiently. F&C Operations is now principally an oversight function monitoring the outsourced middle and back office activities. It is vital that the front office feels that their needs are being met, and the responsiveness of the outsource provider to queries or questions is prompt and effective. With a much less complex systems environment there are fewer data challenges or issues and with a single core portfolio and order management system transaction management is simpler to monitor. We have built a supplier management and governance framework that we believe works well.

Hassan: The end goal is to provide a better service to your clients, so have you found any positive impact on that side?

Hugh: We’ve had some bumps in the road as one would expect in terms of the migration points and the settling periods following those transitions but these were addressed very quickly. After transferring to State Street’s “enterprise platform” it took us about twelve weeks to return to BAU status and from there we have seen things continually improve. It does enable us to respond to clients quickly and efficiently and we haven’t found any material problem or service provision shortfall that has been detrimental to servicing client relationships.

Hassan: Are there any final thoughts on this topic?

Hugh: We have focused primarily on operational efficiency as a result of outsourcing operations and subsequently redirecting systems spend into improving the front office application suite reducing the risk of distraction to fund managers and allowing them to focus more on investment. However, equally as important is the cultural shift and organisational change that we consciously made to better connect with the front office. Operations and IT are often seen as being an obstacle to getting things done. We have worked very hard to position Operations and IT as an enabler. This has allowed us to engage with the front office in a very different way significantly benefiting the way that we communicate, collaborate and deliver as an integrated team.

Hassan: Thank you for taking the time to share your thoughts on this subject.

“The immediate benefit of the outsource was that we were able to fundamentally reshape our organisational structure”
What are the key factors Chief Operating Officers consider when choosing which parts of the business to outsource?

Hassan Machmouchi: As a large fund manager what would be the key elements you are looking for when selecting/evaluating outsourcing providers and what can the providers do better?

Carolina Corradi: For us, it is first of all about identifying the areas that we are interested in outsourcing. We decide this by referring to our Target Operating Model, it helps define the type of services and activities we want to stay in and others that we don’t consider will give us a real competitive advantage when it comes to providing a unique and special service to our clients.

When we look at outsourcing a key element we consider is the availability of internal expertise; there could be new areas, which we don’t have enough knowledge or resources to supply in-house. In this case, we would typically look outside for providers with that expertise. The Target Operating Model is not limited to operational activities alone as we look at other areas of the business such as marketing, risk management, data etc.

Hassan: So there are essentially two areas; one being where additional services are required where you don’t have the internal capabilities or infrastructure, the other being those areas whereby you feel that there are providers in the markets who have a better infrastructure or higher knowledge base.

Carolina: Correct, so in terms of criteria we tend to select providers based on their models as well as the maturity of these models. The quality of their services as well as the geographic coverage of the services they provide are relevant, particularly when you consider that Pioneer Investments’ activities span 27 countries from Australia to North and South Americas. Financial stability and price for the services are two other factors that we look at when selecting our providers.

Hassan: A lot of outsourcing initiatives are clearly done from a cost saving perspective but it seems to me that you are looking at it from a much broader view. Am I right in thinking that the cost element is done on a value basis rather than simply who is providing the lowest fee service?

Carolina: Yes absolutely. The nature of our business and our past experience with providers has taught us that it is more important to consider the flexibility and adaptability of the provider rather than simply the price of the its services as an element of selection.

Hassan: COOs must oversee the entire operational framework for the organisation and as such are naturally pushed for both resource and time – what must outsourcing providers demonstrate in order to present a genuine solution that would help the COO better manage their limited resources?

Carolina: There is no single answer to this. It depends on the type of service: COO’s requirements could differ for example, between long term engagements such as for fund accounting or custody services, and one-off offers or standalone activities such as marketing or printing. Scale is important in terms of finding providers who can supply as many resources as required and also those who have the ability to deal with downsizing and increasing volumes on both sides.

The most important element for us is finding providers who really understand our business and our requirements, and providers who are quick to respond and adapt their services to what we ask them for particularly in the area of product development.

Hassan: And how has an outsourcing partner helped you to deliver new products to the market in the past?

Carolina: Fund accounting activity is largely a commodity, but over the last 6-7 years our product range has changed quite a lot; for example we have had products in which the use of derivatives has substantially increased and our suppliers have met our request for more sophisticated valuations.

We have used coupons payment intensively, alongside standard fund feeders and multiple hedged classes. While it is true that the nature of the market is also changing, our experience shows we have seen a much quicker change than other asset managers.

The complexity of our business has also increased the number of share classes, which is very high compared to most of our competitors.

Hassan: Is it the complexity of your offerings that is dictating the partners...
What are the key factors Chief Operating Officers consider when choosing which parts of the business to outsource?

that you choose and moreover is it this that is taking up the majority of your operational time?

Carolina: Exactly.

Hassan: The FSA are clear in pointing out that the responsibility for governance and oversight must remain with the parent organisation – does this then mean outsourcing any part of the business will now require additional resources?

Carolina: It is now clear to the regulators and companies who are deciding to outsource that they cannot simply delegate activities without oversight. This requires a defined quality rather than simply a larger number of resources. It is about the type of resources and skills needed and this comes with a higher average cost.

Internally, since 2011, we established rules on how to monitor providers and we tried to cope with the increasing demand for resources by assigning clear responsibility, and designating specific people to manage the providers. We also, where possible, use our subject matter experts; monitoring providers is not limited to one individual like the business manager but involves time, cost management, and procurement of experts in the negotiation of the agreement; or business continuity experts in monitoring the soundness of the providers’ DR and BCP plans etc.

Hassan: As you see the number of outsourcers grow as the business grows do you see potentially a new role available within the company which strictly has this oversight function of those relationships?

Carolina: Typically we would see an outsourcing control function having similar skills and knowledge to the area outsourced. For example if we outsourced fund accounting we would retain people with this type of experience in the outsourcing control function. In addition, negotiation skills and relationship management knowledge are required across the different business roles. Technical knowledge can be added but we really need people with the right set of relationship skills to be in these positions.

Hassan: As well as individual skill sets to be able to effectively monitoring the outsourcing partners responsible for these areas?

Carolina: Yes. Outsourcing is a powerful tool to scale up the capabilities of a company but in a way it is like making the chain longer and you have to be able to skip a few elements of the chain, whilst continuing to keep control over your provider. You also must remember that the outsourcer themselves may outsource or offshore part of their activities as well.

Hassan: How do you then get control over what they are doing, it must become very difficult?

Carolina: Over time we are changing and adapting the outsourcing control functions, they are moving towards the due diligence side rather than just ticking KPI boxes.

Hassan: I like the point you make about having an organisational structure to these oversight programs for your outsourcing partners. Would you recommend that as a good logical step for companies who are new to outsourcing initiatives?

Carolina: Absolutely, this helps us maintain our ability to expand outsourcing without having to increase the number of staff. It has the benefits of controlling the overall cost of outsourcing but also it is very useful for transferring the knowledge of the relationship; it would be a big mistake to keep the knowledge of the provider limited to just a few people as the more you communicate the better the knowledge.

Hassan: Would you say that having this clear, defined organisational structure has freed up your own time to allow you to focus on other aspects of your job?

Carolina: Yes. A lot of the benefits are for our people in cost management because they can benchmark prices and quality of providers; so when they support the selection of a provider they have a lot of knowledge to leverage. There are also benefits of scale. For example, a few years ago we created an outsourcing control unit for security services which was essentially overseeing one relationship and today the same group is overseeing three large relationships.

Hassan: So it is a natural evolution between your business and the relationships that you have built on the back of that expansion? Would there be any parts of the business that are naturally easier to outsource whilst maintaining the necessary level of oversight?

Carolina: The decision around outsourcing is naturally related to the maturity of the services and the availability of providers; and typically these two elements are strongly related to one another.

Fund accounting and transfer agency are obvious candidates for outsourcing by an asset management
company. As far as the middle office is concerned, there are other areas that are becoming almost commoditised for example pricing, derivatives as well as performance measurement and risk management reporting.

If there are established providers the selling proposition is easier. Decisions are influenced by on the cost element, as clearly it is an important factor, but particular importance is placed on the control framework, i.e. whether the providers are able to reassure you that they know what they are doing and that they have an extensive experience in providing services to other financial companies.

**Hassan:** How important is the reporting back to you from the provider and how much does that dictate the level of confidence that you have in that provider?

**Carolina:** Typically the level of reporting is standardised so there is basic information that is provided to every client by the provider; then the level of details, automation and interaction can vary client to clients.

Direct access from the client onto the provider applications is key in certain areas; specialised reporting is what we look for.

Another important element is the ability of the provider to project manage and their transparency in dealing with changes. This is where in the past we had the vast majority of risks.

**Hassan:** Do you have any further thoughts on this subject?

**Carolina:** I have heard it mentioned in many round table discussions the idea of the second wave of outsourcing, that is when outsourcing arrangements come to their natural end and companies evaluate a change of providers. Typically this is a very big project effort and the cost of services to be provided is not usually the only element influencing the decision because the initial investment in terms of people and money can be huge.

Even when you are looking for a new provider price agreement is not the only decision making factor.

**Hassan:** It is all about the abilities of the providers rather than simply a cost function.

**Carolina:** Absolutely as we mentioned at the start it is about the added value.

**Hassan:** Thank you for taking the time to share your insights into this topic.

“We also, where possible, use our subject matter experts; monitoring providers is not limited to one individual”
The Compliance Function and Monitoring Programme: Some Views from Malta

Introduction

In the aftermath of the financial crisis, policy makers revamped financial regulation in order to strengthen the requirements that contribute towards systemic stability and investor protection. In addition, financial supervisors adopted an agenda of more intense supervision of financial entities and stronger enforcement action where breaches of regulatory requirements are identified.

Recent events demonstrated that even large financial entities that in the past appeared to have suitable compliance risk-mitigating procedures in place were in reality deficient and have, as a consequence, been subject to regulatory censure. Regardless of size and nature, financial entities need to be constantly up to date with regulatory developments and must alter and renew their business processes in order to come in line with the new regulatory landscape.

Failure to adapt to regulatory change could have a negative impact on a financial entity’s relationship with its financial supervisor. Repeated compliance failures could potentially lead to enforcement action.

This paper examines certain elements of the compliance function and the compliance monitoring programme for the observance with regulatory requirements.

Compliance Function

It is reasonable to suggest that the financial crisis and scandals, such as the libor scandal, can be largely attributed to weaknesses in governance arrangements. The governance structures of financial entities proved to be insufficient to safeguard against excessive risk-taking and inappropriate practices such as financial product mis-selling.

As a consequence of the identified governance weaknesses, financial supervisors are placing more emphasis on examining the governance of financial companies and their compliance function, particularly the extent of resources allocated to this function and the technical ability of compliance officers. In Malta, potential candidates for the post of compliance officer require regulatory approval. These are presently being subject to a rigorous competence assessment, which assessment is critical to ensure that the compliance function has the expertise and technical resources to meet the challenges that emerge from the new regulatory landscape. In addition, to effectively perform his/her role as a compliance officer, the designated official is generally required to be an independent and experienced individual who holds an appropriate level of authority within the financial entity. It is of no use having a compliance officer who does not have the personality to stand up to his Chief Executive Officer when a serious compliance matter arises.

The compliance function has the central role of setting the procedures for compliance with regulatory requirements. It generally also has an advisory role supporting management in discharging the financial entity’s regulatory obligations and an oversight and enforcement role in monitoring business activities. With regard to the latter function the compliance officer is generally expected to: [i] identify potential areas of compliance vulnerability and risk; [ii] develop and maintain corrective action programs for resolution of challenging issues; and [iii] ensure proper reporting of any violations to financial supervisors. In this connection, the compliance function is also the central hub through which all interaction with regulatory and enforcement bodies should be channelled. For this purpose, it is important for the compliance function to develop an open dialogue and on-going communication with financial supervisors. Dialogue and communication ensure that financial entities can seek the views of their supervisor where difficulties in implementation arise, thereby avoiding incidents of non-compliance.

Compliance risk is an inevitable part of any financial entity’s business. Issues of material non-compliance, such as financial product mis-selling or breaches of other fundamental conduct of business rules, could have a significant impact on the welfare of the financial entity’s clients and, as a result, a devastating effect on the financial company’s reputation. It is therefore of strategic importance that financial entities have a properly operating compliance function which monitors and safeguards the integrity of the entity’s conduct of business with clients and other stakeholders. In this connection, to ensure its effectiveness as a risk mitigation and governance tool, the compliance function should be a separately identifiable unit within the organisation, autonomous from other operating units. Moreover, the compliance function should have clear and effective reporting lines to senior management and enjoy direct access to the board members when the escalation of issues is required. It is also crucial that the internal discussion on compliance issues does not end
at the level of the compliance function but that compliance becomes a standing agenda item for senior management and the board of directors to enable proactive management of regulatory risks.

**Compliance Monitoring Program**

The compliance function is generally required to establish a program for monitoring compliance that takes into consideration all areas of the financial entity’s activity. The purpose of the compliance monitoring program is to evaluate whether the financial entity’s operations are being conducted in compliance with its regulatory obligations and whether its internal guidelines and controls remain effective and appropriate. The influence of regulation on the financial entity’s activity and its regulatory risk appetite are more often than not the key drivers of regulatory and compliance arrangements.

The establishment and maintenance of an organisation’s compliance efforts are the ultimate responsibility of an organisation’s board of directors and senior management. Accordingly, it is generally required that the contents of the compliance monitoring program should be understood at executive level. Furthermore, the senior executives would be expected to exercise adequate oversight over the programme’s implementation and ensure the appropriate implementation thereof.

Nevertheless, compliance cannot solely represent the object of a specialised function. Rather, it should be recognised as being of fundamental essence within corporate culture and must infuse the organisation at all operational levels. Compliance monitoring programmes should be part of a broad compliance culture and coordinated accordingly among all business areas within an organisation.

Reviewing the compliance monitoring programs is fundamental to maximise their effectiveness. Financial entities ought to periodically assess the compliance risks facing the organisation and take the necessary initiatives to modify elements of the compliance programme to mitigate the risk of improper or unethical conduct. This assessment can assist the senior management in identifying areas of weaknesses and strengths within the organisation.

**Conclusion**

The dynamic development of the financial services industry is making the identification and control of behaviour that could give rise to breaches of regulatory obligations and internal company policies even more complex. Developments in international regulation have increased the importance of compliance work exponentially and this has, in turn, led to higher compliance personnel costs and outlays on internal systems. Although it is difficult to quantify the value added of having good compliance procedures in place, penalties and censure are the potential consequences of non-compliance, including those relating to reputational risk. Compliance failures represent a significant regulatory risk that cannot be eliminated. However, with precise attention and thorough implementation of a robust compliance function and monitoring programs, the risks can be alleviated significantly. Compliance assists firms in the pursuit of growth as well as dealing with ongoing challenges and helps enhance corporate value, improve reputation and create competitive advantage in line with growing stakeholder demands around integrity, accountability and financial stability.

“Reviewing the compliance monitoring programs is fundamental to maximise their effectiveness.”
Malta’s financial services centre offers financial institutions a combination of the essential ingredients for success: convenient location, rapid access to market, effective regulation, rock-solid legislation, accessible authorities and a pool of highly competent, experienced professionals.

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Success depends on getting it right - Malta is getting it right.

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SECTION 2

REGULATORY CHALLENGES

2.1 INTERVIEW
How regulations and commercial pressures are likely to impact the sourcing strategies of global asset managers in the future

2.2 WHITE PAPER
Outsourcing in a post–AIFMD world
2.1 INTERVIEW

How regulations and commercial pressures are likely to impact the sourcing strategies of global asset managers in the future

Jenna Gadhavi: How have recent AIFMD and proposed UCITS regulations added additional operational burdens to the way you are managing current and future planned initiatives?

Markus Ruetimann: The AIFMD has created a new framework for key functions such as valuations, leverage and risk management as well as reporting and notifications which have inevitably increased the operational burden. In the weeks since the new regime was implemented, we continue to automate various components of the associated operational processes to the point at which we will be able to compute all checks daily as a matter of preference. We have also allocated a number of analysts who will test the risk models applied and will fine tune them over the coming months where required.

We consider UCITS V a “retrofit” to AIFMD standards. There are therefore limited operational impacts for our relevant Management Companies. Early interpretations of the emerging regime on remuneration suggest that our Management Companies are unlikely to have to change their current approach in a material way.

Jenna: What key areas would you potentially consider outsourcing and what benefits would the providers have to deliver in order to make this viable?

Markus: There are three potential services we might consider for outsourcing in due course - the lifecycle support for OTC derivatives, the production of data for external consumption (either by investors and/or regulators) as well as the mining of specific data for multiple sources.

We haven’t found a provider yet whose operational and technological support for OTC derivatives is mature, scalable and extensive in terms of instrument coverage. Component-based outsourcing for collateral management, valuation and reporting is available, but would not necessarily deliver the integrated approach we are eventually seeking. In addition, service solutions are evolving as regulations such as Dodd-Frank and EMIR continue to change operational and reporting requirements.

We might also be tempted to consider the use of an external provider for the collation and distribution of information to investors and/or distributors. These could include fund fact sheets and/or Key Investor Information Documents (KIIDs). However, the problem with such an approach is that we have to make sure the data is quality assured in-house so that the role of an external provider would be rather limited.

With regard to data mining, we are, for example, teaming up with external partners in our endeavours to find additional sources for Alpha based on the vast amount of information available on the internet and various information hubs.

Generally, we are pursuing a sourcing strategy that appropriately and proportionally supplements our in-house talent pools with services bought from outsource and co-source providers. The latter is primarily in the space of information technology, information security and data mining.

Jenna: Regulatory obligations form the backbone of most operational investments, but what must fund managers take into account in order to make those investments both sustainable and adaptable?

Markus: Regulatory compliance will be part of business-as-usual and has already, at least in parts of our organisation, become integral to our operating model and to our client service propositions. Schroders operates in 27 different countries across Europe, the Americas, Asia and the Middle East. Ensuring compliance with national regulations thus requires a substantial resource commitment.

Like anyone else in the financial services industry, we are running a number of projects that had to be initiated in response to prescriptive regulations. Across the user community, we endeavour to co-ordinate the discovery, analysis, visualisation and sharing of the relevant data across as many teams as possible. The changes required in our IT architecture are carefully planned and co-ordinated to avoid or to minimise duplication of effort. Operational agility is ensured by employing competent and experienced people who can deliver client services and projects in a safe and resilient way.

Whenever we are launching a new investment fund, we endeavour to utilise existing operational processes...
How regulations and commercial pressures are likely to impact the sourcing strategies of global asset managers in the future and systems. This allows scalability of workflow and advances time-to-market.

**Jenna:** As regulations coalesce and impact across financial services – EMIR and Dodd Frank being a prime example – how can fund managers make sure they are prepared for future regulatory developments outside of their core business which will nevertheless have strong impacts on their operational infrastructure?

**Markus:** Regulations are very “data hungry”. This is not just a challenge for us, but also for our service providers and counterparties, such as brokers. We all want data from each other in order to fulfill our regulatory reporting requirements. As an obvious result, yottabytes of data flow from system to system, from data warehouse to data warehouse. It remains unclear how many “bytes” are in effect analysed by the respective regulator.

The regulatory timetable can unexpectedly accelerate or slow down. ESMA’s announcement to phase in the mandatory clearing for certain OTC interest rate and credit products over 18 months clearly took the industry by surprise. ESMA has also declined to make any class of OTC equity derivatives subject to mandatory clearing – at least for now. Events like this make operational planning tricky.

One can safely predict that regulation will become “a way of life”, not only for Group Compliance officers, but also for the teams in Client Servicing, Legal, Operations and IT. Adequate and skilled resources, efficient internal information sharing with respect to impact analysis of emerging regulations as well as an agile IT architecture seem logical attributes essential to the long-term competitiveness of an asset manager.

In our operating model, our core hubs in London, Luxembourg and Singapore are well equipped to run and change an operational infrastructure in accordance with requirements from clients, intermediaries and regulators. EU Regulations on OTC derivatives, central counterparties and trade repositories are now being copied and enhanced by other jurisdictions. EMIR trade reporting requirements will soon come into effect in Singapore, Hong Kong and Australia.

**Jenna:** Do you believe, on balance, that regulation protects end investors more now than a few years ago?

**Markus:** This is hard to predict. The regulators’ interventions have no doubt created much improved transparency with regard to fees, commissions and investment risks. They have also raised the bar with respect to the business conduct and governance structures in parts of the financial industry. One can, however, not be certain whether a “rogue trader” or “miss-selling” are destructive events that can be avoided by prescriptive regulation in future. One could argue that the cultural strength, the integrity of senior management, the effectiveness of internal oversight structures and the quality of the employees are the key ingredients of our industry’s future success and survival.

**Jenna:** Thank you for sharing your insights into this topic.

“**The AIFMD has created a new framework for key functions such as valuations, leverage and risk management**”
2.2 WHITE PAPER

Outsourcing in a post–AIFMD world

The AIFMD

The deadline for implementation of the AIFMD, 22nd July 2014, has now well and truly passed. EU-based investment managers (“AIFMs”) are now experiencing the reality of the new compliance regime. The requirements now in place impose additional and unprecedented costs on industry players. There are robust compliance requirements, but also hard costs for AIFMs across a number of dimensions. Some of these are as follows.

- Depositary fees
- Additional costs for insourcing key activities due to increased delegation and substance requirements
- Costs for separating portfolio management and risk management functions
- General costs of compliance, for example, calculating leverage according to ESMA’s methodologies and compliance with other reporting requirements
- Additional capital costs
- Additional professional indemnity insurance cover.

The Directive also places restrictions on the remuneration of key employees within the investment manager and imposes claw-back arrangements in relation to bonus payments.

Perhaps unsurprisingly, many AIFMs with limited activities in the EU are considering whether to adjust their operating models to fall outside of the AIFMD net and hence avoid the constrictive compliance framework.

For AIFMs that are closed for new subscriptions, do not actively promote their product, or who have a small investor base that can be accessed using National Private Placement Rules (“NPPRs”), there could indeed be a more flexible solution. This involves combining the AIFMD’s provisions relating to risk management and outsourcing/delegation, moving the AIFM outside of the EU and thereby neatly avoiding the most onerous regulations.

Risk Management

A key requirement of the AIFMD is that the risk management function should be functionally and hierarchically segregated from the portfolio management function up to executive level in the business. The risk management function should operate entirely independently and with adequate expertise, authority and resources, to ensure that risks in the AIFM and in the funds themselves (“AIFs”) are identified, quantified, and managed appropriately.

For many investment managers, particularly smaller entities, it is not easy to re-structure their organisation in this way without adding new personnel. This adds further to the already significant cost burden of compliance with the Directive. Many investment managers have looked into outsourcing aspects of the risk management function to third party risk consultancies to avoid the necessity of organisational restructuring. However, this needs to be considered carefully, as the Directive also contains key provisions on delegation.

Delegation

The AIFMD states that the AIFM cannot outsource/delegate functions to such an extent that it becomes a “letter box entity”. Although a rather generic term, it is being interpreted that the AIFM cannot delegate activities so substantially that it becomes essentially a “shell”. The AIFM must retain enough substance, activity and expertise in either portfolio management activities, or risk management activities, otherwise it will be necessary to comply in full with the Directive’s provisions.

Moving “Outside the Net”

The objective is to move the location of the AIFM from the EU to a non-EU jurisdiction such as Jersey. The AIFM will then fall under the definition of a non-EU Manager, and can market its products into the EU via the NPPRs in place in Member States, subject to certain requirements.

This is achieved by incorporating a new AIFM entity in the non-EU jurisdiction, appointing a new board, and allocating the entity functional responsibilities for risk management. This new AIFM then delegates portfolio management responsibilities back to the existing EU portfolio manager. The new AIFM thereby avoids the vast majority of the AIFMD’s compliance requirements, while the EU portfolio manager operates under the existing onshore regulations in that capacity only. The new AIFM will have some local provisions that need to be adhered to, but these are much lighter relative to the AIFMD regime.
Outsourcing in a post–AIFMD world

In relation to Jersey, an existing compliance regime is in place to facilitate exactly this solution. The new AIFM entity can be administered under the Manager of Managed Entity ("MoME") class of fund services business established under the Financial Services (Jersey) Law 1998. A Jersey company will be incorporated to become the AIFM, upon which local staff will act as Directors, along with existing Directors of the investment manager. Dedicated risk management staff will be provided to establish a robust risk management framework and to carry out the function going forward.

The Jersey AIFM would be an entity regulated by the Jersey Financial Services Commission ("JFSC") and can be branded as required by the investment manager. In that connection, in addition to the AIFMD delegation provisions (see above), the JFSC's normal licensing policy would apply to the new investment manager and it would be subject to the requirements of the JFSC's outsourcing policy in connection with the delegation of its functions to the onshore investment manager.

The schematic below explains how this will work in practice. This is for illustration only and the concept can be applied to self-managed funds or non-corporate structures, for example limited partnerships and unit trusts.

In this way, a neat solution is found that not only solves the issue of segregation between risk and portfolio management functions, but also circumvents many of the prescriptive AIFMD requirements and their associated costs.

Conclusion

The breadth and complexity of the AIFMD, and to some extent a lack of clarity over terminology and its interpretation by national regulators and ESMA, has made compliance with its provisions something of a nightmare for small to medium-sized investment managers. Even after a one-year extension of the transitional period, there are still many investment managers left scratching their heads. For many others, fundamental changes have been required to their modus operandi. However, full compliance is not necessarily the only solution. The right cocktail of jurisdiction and risk management delegation could well provide a more practical solution for many managers.

“The requirements now in place impose additional and unprecedented costs on industry players”
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SECTION 3

GOVERNANCE AND OVERSIGHT

3.1 ROUNDTABLE DEBATE
Striking the balance – defining outsourcing programmes to meet business objectives whilst maintaining internal oversight

3.2 WHITE PAPER
Fund oversight taking centre stage

3.3 INTERVIEW
What must service providers deliver to help the COO better manage their time and resources?
3.1 ROUNDTABLE DEBATE

Striking the balance – defining outsourcing programmes to meet business objectives whilst maintaining internal oversight

Moderator

Pádraig Floyd
Freelance Financial Journalist, Money Journey Media

Panellists

Susan Wright
Senior Adviser, Regulation, Investment Management Association

Stephen Lowe
Head of Middle Office and Investment Operations, Royal London Asset Management

Laura Weatherup
Head of Investment Operations, Threadneedle Investments

Padraig Floyd: How have your current outsourcing projects helped in delivering key business objectives, and has there been anything you feel could have been done differently or better?

Laura Weatherup: The key objectives we have are to focus on our clients and meet their needs. The core value we add is through the fund management, which is managing our clients’ money, including managing the risk and return effectively and well. The second element is around distribution, which focusses on selling the right products and solutions to our clients as well as servicing our clients. The outsourcing arrangements have supported this because they take away those things that are separable from the core value add that we have.

If I look at the transfer agency (‘TA”) services we have outsourced, we chose horizontal integration by that I mean we have one TA across the regions rather than bundling TA with investment operations and custody. The reason for this is that we are able to provide a better and more consistent service to our clients across multiple products in multiple regions. For example, we have UK, European and Asian clients some of whom will invest in products domiciled in the UK and Luxembourg, so by having one firm supporting all the investor registers, it provides a more consistent client experience, we felt that this was a specific value add that we could get from outsourcing.

The objective for Investment Operations is to be on a strategic multi-client platform. We partner with large global banks, who are also specialists in administration; this enables us to leverage their expertise and their continued investment into and development of their operating platform. It also means that we are one of a group of asset managers serviced by the same provider, who can benefit from collaborating together and working with the supplier on a range of subjects such as platform development, regulatory change etc.

Stephen Lowe: RLAM partners with specialists in these services and we want to be on a strategic multi–client platform and gain from the benefits this brings. This is aligned to Laura’s observations.

Susan Wright: We have found questions coming from member firms with regards to their outsourcing activities any time there is a consultation or policy statement from one of the regulators. Firms have focused very much on who does what for them and many firms are telling us that the management information ("MI") they are getting back from those service providers where they have outsourced an activity is now much more detailed, and at the same time we are finding that the service providers are much more open to having this dialogue with firms. Before this, it was very much ‘here is your monthly management information ("MI") pack’, but now the conversation is more likely to be ‘what would you like to see in your monthly MI Pack?’

Firms are also looking at some of their non-UK business. Across Europe it is a little easier as you can obtain information as part of the MiFID Directive requirements. But firms are also looking at some of their business activities outside of Europe to look at who does what for them - how well do firms know the providers are doing an activity for them, which links back to that firms’ key objectives and therefore could have an impact on the underlying investor.

Padraig: Can you elaborate on the key elements you look for when doing a risk analysis of a prospective outsourcing partner?
Susan: One of the key elements that people are looking for more is bespoke MI. Laura and I have both worked on the outsourcing working group (OWG) and one of the things it has encouraged is for managers to actually request what it is that they want from their providers. They (the firms) can think about their own business, the value of MI and what use it is to them rather than just accepting it. There is more due diligence being carried out by firms and that has also been an aspect from ESMA and the Financial Conduct Authority (FCA). Outsourcing an activity is no longer just about transfer agency and fund accounting, but the whole scope and remit of a firm’s activities

We are also seeing many firms now looking at exit planning which is always a difficult subject with a new provider.

Laura: We have done this type of risk assessment recently, and have a large spectrum of elements that fall under risk analysis when we are looking at a prospective outsourcing partner. This is partly because these arrangements are critical services and are incredibly expensive and complex to implement so it is important to get it right and future proof the services that you get.

One of the key points we look at is the strength of the balance sheet and the corporate structure, so who is standing behind the services that are being provided, how strong they are and what their credit rating and balance sheets look like. We look for people to be global leading market providers and to ensure that the operating platform that exists supports our current known and expected business requirements. We have considered the requirement to be able to support multiple front office locations and the ability to support multiple local product domiciles, so a large geographic footprint is important for our Investment Operations provider to have. When we looked at custody, particularly in the light of some of the changes relating to AIFMD, we were looking for global custodians with a large proprietary/affiliated sub custodian network.

Threadneedle also looks at the history of the technological infrastructure of the firm and the investment that they make into technology, as this gives you information about the ability and likelihood of that firm to continue to improve or develop their platform to keep pace with industry and regulatory developments.

We also look for evidence of strong delivery in terms of execution of the services, including assessment of error rates, regulatory compliance etc. We would perform due diligence to understand the strength of their control environments including internal audit, compliance, operational risk, BCP, disaster recovery, external assurance reports etc. We also look at how the provider controls the processes they perform and how they would evidence to us their delivery of the services.

We look to ensure that the corporation has a strong migration approach and a history of execution of large complex migrations and we would expect to be able to negotiate strong legal protections, which is a core part of commercial negotiations but is also indicative of the confidence the supplier has in their own services.

We look for strong change management discipline, including a demonstrable process and delivery of large books of change. Part of this means we expect the supplier to work in partnership with us, to be raising regulatory changes they know about and be experts in that area as much as we are. Accountability for regulatory compliance remains with Threadneedle; however we do look to be able to leverage the knowledge and expertise of our suppliers.

“We are also seeing many firms now looking at exit planning which is always a difficult subject with a new provider”

Threadneedle also looks at their management team and that would include the senior management team and the operational delivery team as we seek to understand the experience and capability of the team responsible for service delivery. Some of the items we look at include staff turnover, time with the current supplier, training and development and the experience of key individuals. We aim to get a feel for the teams attitude, the way those teams work and how they would engage with us as a potential partner in serving our clients.

We do also look at exit planning and that is regardless of what the trigger is. We seek to include exit planning expectations in our due diligence and contract negotiations.

Lastly, we would then look at the commercials. One of the big pieces that we do around risk analysis for these types of arrangements is seek to ensure that the arrangement is profitable for the supplier, as a successful outsource relationship needs to be commercially sound for both parties. So you’ve got to understand the commercials and ensure that both the supplier and the asset manager are getting a good deal.

Stephen: Laura has summed it up extremely well! I would concur with all of Laura’s comments on these points.

Padraig: How much time are you currently spending on internal oversight of outsourced initiatives and what procedures have you set up to help in managing your time more efficiently?
Laura: We have two large outsourcing arrangements, one is investment operations and the other is the retail oversight which covers transfer agency and pension administration. There are about 10 FTE performing oversight on the TA and pension administration arrangements. The key areas they cover are BAU oversight, management and resolution of issues, process improvement, contract management and SME input to change.

Within Investment Operations I have a team of 30 people including myself, of which 8 are focused on change management i.e. delivery of change by our suppliers whether it is transfer agency or investment operations.

There are then 20 people who are focused on the oversight of investment operations. We currently have three suppliers who cover middle office, fund accounting, custody and some of the ancillary services such as report and accounts, investor tax, derivative processing and share class hedging. Those 20 people who are focused on oversight are also the SME so they would support the large changes that we’ve got such as regulatory changes or operating model changes as a result of new product launches and or client take-ons.

Padraig: That is quite a lot and a major function clearly.

Laura: Yes it is and it is in the order of 10% of the people that would be providing those services were they in house.

Padraig: Susan what are your thoughts on this?

Susan: We tend to see it from the other side as we have held a number of workshops and roundtables on outsourcing with our member firms. We are starting to see the title of outsourcing appearing within people’s roles now which we didn’t see previously, as it was something that operations just included within their roles. We are also seeing a move away from the term client relationship in such job titles and instead firms now have a head of outsourcing role, as well as outsourcing management and outsourcing oversight teams.

Padraig: Does the panel foresee additional pressure from the FCA to increase internal oversight and to what extent would this affect your future planning?

Susan: Now that the FCA have completed their thematic reviews on outsourcing and published a report of their findings, we are seeing firms outlining the traditional three lines of defence: operations, compliance and internal audit. It will be interesting to see in a few years’ time if the FCA will revisit this topic because as Laura says, firms are now looking a lot more towards the financial capability and the real regulatory understanding across the service provider community so you do wonder if some of the smaller service providers will have faded away, should the regulatory-capital burden become too much. Indeed we have recently seen one of our smaller asset management member firms move to one of the larger players in the transfer agency (TA) world – is this the start of a trend? Will this make the service provider industry more concentrated, or ensure there is actually more focus on service providers.

Laura: I think the FCA focus is on making sure that people have effective oversight rather than just increasing internal oversight activities and this is a good and positive thing. If firms simply increase the number of people within oversight teams and they perform a series of activities that aren’t particularly well thought through that is not at all what the FCA are going to want and those firms are going to be very upset at the FCA response when they come and look at their oversight practices.

There is a huge focus on Know Your Outsourcing (“KYO”), that has always been a core focus for us and we have always sought to build a good understanding of what we’ve outsourced and how the supplier provides those services. We have very detailed service definition that sets out all of the services provided and the standard to which those services are expected to be delivered to. It is about understanding what is being outsourced, how that service is being delivered, where is it being delivered from, who is doing it, what type of technology is being used etc. The future planning needs to include on-site visits, we do perform on site visits which are a mix of assurance or audit style reviews, process walk through review etc. but it depends on what we are looking at, and why. We do a number of on-site visits and will do more with new providers until we get to know them, understand the key processes and get a feel for the control environment. We use some of these visits to get comfort of over the MI that we receive, if you are relying on the MI that you are being given you need to know that it is being given from a robust and controlled way.

As people are planning they need to focus on demonstrating effective oversight which isn’t about filling pages of check lists or producing reams of documentation, but the oversight that you do needs to be appropriately evidenced.

“This is a huge focus on Know Your Outsourcing "KYO"…”
One area for future consideration is how technology can help with oversight; to be successful it has got to increase the effectiveness or efficiency of the oversight team. In the wake of the Outsourcing Working Group ("OWG") paper a lot of firms are out there who are pushing various technological solutions that assist with oversight and I feel that we have to consider these very carefully as just because it is a piece of technology or system doesn't necessarily mean that it gives you a higher value output or a better insight into what the supplier is doing for you. However, as we get to more complex arrangements of outsourcing there is certainly potential there for some type of technology to help whereas oversight traditionally has not had a system that supported it in the past.

We have found that awareness and oversight of outsourced activities has been escalated within firms to more senior roles. However as such people are often at a senior level in order to take responsibility for the outsourced activities, are also very busy with their own roles. Therefore all of these questions that Laura mentioned regarding efficiency means there may be a number of technological solutions or proposals that could prove useful in relation to having key MI (rather than lots of MI) in order to pick out quite quickly the key issues.

Laura: It is also about having the right oversight team with the right mix and balance of experience and capabilities to effectively oversee the outsourced services. It isn’t about having a system that simply re-performs elements of what your supplier does, as they are the experts. As a firm outsourcing key activities you need to make sure you have an expert oversight team that isn’t an expert re-performance team – and they are very different skill sets.

Stephen: I would agree with the sentiment here. I think all clients need to understand their outsourcers and have an experienced team in place with an agreed governance structure in place with the provider.

Padraig: Thank you both for taking the time to share your insights into this topic.

“"The FCA focus is on making sure that people have effective oversight rather than just increasing internal oversight activities ""
Regulatory Pressure & Brand Protection are Key Drivers

Recent market surveys and reports have indicated that pricing pressures are squeezing asset managers’ margins. There is an expected move towards more price variability across managers, and only those achieving measurable alpha for their clients will be able to apply premiums. Against that background, it is no surprise that many asset management companies are sensitive to both regulatory attention and brand protection as they assess their operating models to institute the most efficient and cost effective mix of in-house and outsourced activities. They are therefore, also taking the opportunity to review their associated fund oversight functions and processes in order to establish whether they are appropriate and fulfilling their fiduciary obligations to clients.

This perspective is driven in part by recent regulatory scrutiny. Across Europe and further afield, regulators are actively reminding asset managers of their fiduciary responsibilities and reinforcing the requirement that they maintain appropriate levels of skill, expertise and process in-house to oversee outsourced administration providers. The UK’s FCA has been the most active in this area both through its Dear CEO letter in late 2012 and more recently the publication of a follow-on thematic review in November 2013.

The thematic review focused on the areas of resilience risk and oversight risk. With the latter, the FCA identified four areas where it repeatedly saw deficiencies in oversight processes: reconciliation between custodian and administrator; pricing and valuation of portfolios and their constituent instruments; corporate actions affecting instruments held; and trade processing quality.

At the recent annual FundForum International conference in Monaco, a session was dedicated to the topic of oversight with panellists confirming that regulators in almost all of the major global fund centres have recently been active in this area: Bank of Ireland, CSSF in Luxembourg, BaFin in Germany, FINMA in Switzerland, along with the USA, Hong Kong, Singapore and Australia.

The regulators’ interest is timely. The advent of government-mandated pension auto-enrolment in the UK, combined with the widespread trend of moving from defined benefits to defined contributions across Europe, has altered the marketplace in subtle but important ways. In particular, by generating a new and larger cohort of end-investors to be protected along with their long-term savings.

Trust is high on the agendas of asset owners whether they are institutional clients or retail clients and their advisors. Institutional clients are now much more likely to perform extensive due diligence on their chosen asset management partners to ensure that their administration processes are robust and fit for purpose – along with regular detailed reviews.

Where retail clients are concerned, recent reports have highlighted the importance of trusted brands for this segment with new statistics suggesting that:

- Out of the 70,000 share classes in the global market, only 185 (0.003%) hold almost 100% of the FUM
- 90% of net UK investor flows last year went into only 10 funds

The cost of investors losing trust in a brand is therefore huge compared to the cost of protection. A series of material valuation or administration errors for an asset manager can have a significant impact on their client relationships – especially if the news makes its way onto social media platforms - as well as with their service providers and other key stakeholders. These events take management teams’ time and energy to resolve, and recovering trust in a brand can be challenging with all of this ultimately being borne in lost revenues.

A recent Milestone Group survey of US asset managers on the topic of oversight also suggested that brand and reputation are top of the list of reasons to be reviewing the current oversight function. In Australia compulsory investment into a

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4. Article on FT.com, http://www.ft.com/cms/s/0/4942b1b6-6d3d-11e3-8ca9-00144feab7de.html#axzz36tfdog5Q
Fund oversight taking centre stage

personal pension has been in place for a number of years. There, a recent unit pricing outsourcing survey of asset managers was performed by the Financial Services Council found that 100% of the respondents conducted an independent check of the NAV movements for their funds each day.

Typical Fund Oversight Models Operating Today
All asset managers in Europe will have some form of oversight of their outsourced fund administration partners in place. However, the extent of the oversight varies considerably between asset managers, from those who rely on monthly report cards from their service provider and monthly review meetings to those who have shadow accounting practices in place.

Many occupy the middle ground, where a fund oversight or fund control team reviews daily valuation data sent from the third-party administrator(s) to try to identify any anomalies so that they can be verified with the service provider. This process will either run before the fund’s NAV is sent to the market so that NAV errors are minimised, or after the NAV is sent but before any valuation problems risk creating loss events.

Typically these teams spend a large proportion of their time manipulating the data that arrives from their many service providers in different formats. Following manipulation comes the running of controls that have been built up over time and represent a history of past valuation errors and often fading knowledge of the specific internal workings of the funds. The teams are largely supported in this task by spreadsheets that may be straining under various pressures. The solutions are often not well understood and lack the flexibility to support changes to outsourcing models or the growth in fund volumes through a merger or acquisition.

Fund oversight processes have perhaps been neglected in recent years as the focus has been on the plethora of other regulatory-based issues that have been thrown at the asset management industry. However, they are now firmly on the agenda as asset managers look to maximise the benefits from their outsourced relationships, achieve efficiencies, or run pre-NAV distribution release checks as well as more detailed post-NAV release controls. The process needs to be efficient, robust and right-sized.

Best Practices in Fund Oversight
Asset managers are increasingly recognising fund oversight as a core business process subject to the same operational control and automation principles as any other.

Individuals involved in the oversight process need to have the appropriate knowledge and tools to understand the detail behind the controls they are running to ensure that there are no issues with the funds’ valuations, often within tight time windows.

The process needs to be efficient, robust and right-sized and also flexible and responsive to meet the ever-changing demands of evolving products and service provider relationships. This process needs to be supported by a dedicated fund oversight system which automates the onerous, time-consuming tasks whilst focusing the team on resolution of exceptions where their skills are most valuable. Emerging ‘best practice’ characteristics for an effective fund oversight function include ensuring that it is:

- Independent – of the third-party provider’s internal controls rather than duplicating them – both in terms of the controls performed and of certain data used in these controls.
- Timely – controls must be run as close to market release time as possible. Given technological advances it is possible to run pre-NAV distribution release checks as well as more detailed post-NAV release controls.
- Efficient – the process needs to be as automated as technology allows, ensuring teams are reviewing exceptions rather than merely processing data.
- Auditable – a full and transparent record of history and actions that is easily accessible is important to both internal and external auditors.

The process must also generate information which supports a learning environment and collaboration with service providers to improve their performance over time.

Time to Take Control
The risks of a weak or incomplete oversight process range from increased regulatory attention through to the loss of both brand value and trust in the asset manager. Equally, the current drive to strengthen outsourcing models is prompting asset managers to re-think their fund oversight approach and tools. The continued trend to encourage individuals to save for their retirement will only increase these pressures.

The fund oversight discipline is moving to centre stage. It is increasingly recognised as a critical business process in establishing and maintaining an effective and healthy outsourced model that satisfies the overarching outsourcing risk management process. The process is now sparking Board-level attention in many organisations, and is undergoing a transformation into an efficient, industrialised operational process that is staffed appropriately, supported with dedicated technology and covering global operations.

The fund oversight discipline is fast becoming a key design feature of outsourced and hybrid fund administration models. By establishing the oversight function appropriately, that investment can quickly become a real business benefit.
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What must service providers deliver to help the COO better manage their time and resources?

Jenna Gadhavi: In your view what key priorities must service providers understand in order to be able to design and deliver effective time-saving outsourcing solutions for your business?

Karen Zachary: It is all about the Service Providers’ understanding of the clients’ product range and distributor and investor requirements. Superior service is critical and second priority to performance when performance is good. It moves to first place in times when performance suffers to focus the asset managers on retention.

It is about understanding their product range and the specifics defined within the product that suggests that certain things need to be delivered to certain clients, investors, distributors and platforms in a timely manner. They also need to understand those drivers in order to service them.

If you look at the custodian side then it is much more market defined as it is prescribed to times the Service Providers have to settle trades within a certain timeframe etc. However, if you are looking at the administration service transparency then this is all about understanding the product and the end investors’ needs. This can become lost if they are focusing on a defined service level agreement and build out infrastructure that becomes more factory-like. The Service Providers have a tendency to just process whilst forgetting that there is a requirement to service the clients who have invested into the end products.

Jenna: So there is a danger of it becoming more about ticking boxes that were agreed from the outset, rather than assessing the processes as they go along and making sure that they are continuously providing that service?

Karen: Yes and the priority should be their product and understanding what the asset manager is trying to achieve, which is growth in assets and revenue for all parties involved.

Jenna: When designing your outsourcing architecture how much time do you allocate towards governance and oversight and how can this be managed more effectively with your chosen outsourcing partner?

Karen: We do spend a lot of time defining this and we have quite a well-developed model of governance which has held us in good stead around Dear CEO.

We have spent a considerable amount of time working with the outsourcing providers on defining how we will work with them in the future on a governance basis. I have spent significant time talking to other fund managers about Dear CEO, our model is well defined; regular service meetings, senior discussions i.e. senior executive meetings with a risk management emphasis, functional meetings that discuss the delivery of the day to day service and more formal monthly reviews.

We have formally defined service level agreements which can be counterproductive at times, as I’ve just alluded to, and we have robust change management process that we agree with the service providers. All of this is mutually agreed and for many of them it is bread and butter, but for some it is more than they have seen before. It has however become more common practice since Dear CEO and although it is a now off-the-shelf for us, we do spend time with them working through that governance framework.

The way to manage it more effectively is to define parameters upfront. Further we appoint an internal relationship manager who is dedicated to the larger relationships with the service providers.

Jenna: What would be considered best practice when organising reporting timelines with your outsourcing partner?

Karen: Again this is about defining it upfront and making sure that our expectations are very clear to them. They are not always able to deliver exactly what you need so flexibility on definition of a monthly report and fund board reporting can be needed. Communication is key on an on-going basis.

Jenna: What auxiliary services can outsourcing partners provide to help you better manage your time?

Karen: We have broader relationships with the banks providing administration services but due to
silos with organisations, cross product selling can be challenging. It seems to be difficult to develop central reporting on all services provided. It would be useful to see the scale of the relationship between MAN Group and “Bank X” from a trading perspective, and the scale of the relationship between MAN Group with them from a corporate perspective as there may be banking and other services offered to our central finance function which would be more for the firm rather than the fund side. They could summarise services/product, on a regular basis, at senior executive review to demonstrate how much business we’ve done with MAN Group over the last quarter.

This can be tough to get from those organisations because they lack cohesiveness, but I do know that internally they do have centralised areas that have oversight over every touch point within a client and this can get lost in the focus on administration services. Central focus on the global relationship that firms have would be very useful from time to time.

We put the banks under increasing pressure to distribute our product and that is incredibly difficult to get information from them to measure success.

The other element that we are getting better at in terms of auxiliary services is more thought from the providers on future state, blue sky planning and what they think strategically in terms of what they are building – whether it be platforms or structures. It helps fund managers know how to take their business forward if they can understand how the entities that support the business are going to push improvement through their infrastructure. Working with them to pre-empt any offshoring activity that they might do, which there has been a lot of noise around of late, so for them to come to us and let us know what they plan to do would help us when the questions arise.

It would be nice to be given information upfront instead of hearing it through the grapevine and then having to dig into whether it affects our business directly or not.

**Jenna: Can you illustrate how your outsourcing programmes have changed as the business has grown and how have these helped you manage your internal resources more effectively?**

**Karen:** We have done significant rationalisation over the last three years around outsourcing. When I joined MAN Group around four years ago we had around 20 different outsourcing service providers. As we've rationalised the business and established our three investment engines, GLG, AHL and FRM (once we had acquired the FRM business), we've aligned our outsourcing arrangements around those three Investment engines and we have strategic partners for each of these three who service the business. Many fund managers will just have one outsourcing partner for the core of their business and we've made a deliberate decision to have one for each of our three core businesses as we have reduced from 20 different providers down to 3. This has reduced resourcing and headcount in the middle and back office quite substantially so cost reduction has been achieved as a result.

**Jenna:** Was that your aim from the outset when you chose to go down the route of having three separate elements of the business or were there other objectives?

**Karen:** At the time I joined we were still doing some work in-house so we were still managing some of our valuations and administration services internally. A deliberate decision post the market crisis a few years ago to focus on outsourcing rather than continue to run the risk internally on managing our administration ourselves. Initially it wasn’t driven around the three investment engines instead more about outsourcing and rationalising the number of providers. As the business has grown and as we have completed acquisitions it has become clear that it makes sense to have a strategic partner for each substantial chunk of assets that we manage.

Each business is run fairly independently. Although the distribution side is joined-up, each of the business lines have their own COO on each platform and we work with them to service each of those businesses through their own strategic partners. There is occasional overlap and decisions to be made when we are talking about launching products that might co-mingle some of the product but aside from that we have kept them relatively separate. We do have Service Providers for our managed accounts which are not substantial in size so the three core providers drive our management and governance model.

**Jenna:** Thank you for sharing your thoughts on this topic.
SECTION 4

OUTSOURCING FOR START-UPS AND NEW FUNDS

EXPERT DEBATE

Taking the first step – what key parameters must be considered when designing outsourcing initiatives?
**EXPERT DEBATE**

Taking the first step – what key parameters must be considered when designing outsourcing initiatives?

**Jamie Lidell:** What procedures would you advise companies put in place to accurately gauge the true value of outsourcing certain parts of their business?

**Melanie Panter:** You firstly have to understanding what you’ve got and how your business fits together. This can bring up surprises when you try to put some of it outside unless you’ve gone through the interdependencies, people, data and systems thoroughly. Costs can suddenly pop up when you didn’t realise that they were shared across multiple teams. One also needs to look at the level of bespoke process and development, and compare that to standard market offerings and what you are trying to achieve on this side of things. It is worth taking a good look at the market and how you stand up against that to almost benchmark your own service first.

It is also important to have a clear view of how your operations fit into your strategy and what your unique selling points are because as sometimes what you are going to get from outsourcing and even what you are trying to get from outsourcing don’t align to your strategy.

It is worth putting in some SLI’s and KPIs between your operations and business as although this seems quite formal and bureaucratic by having a measure of service you have an accurate measure of how your outsourcing service is doing against how the service used to be. From experience the rose tinted spectacles about the old world tend to come on quite easily and this sudden assumption that everything pre outsourcing was perfect, where it wasn’t, is such that by having the metrics there you can back up the reality. Although it does seem a strange thing to do, I would recommend that almost two years before you are going to go into an outsource, if you haven’t got it already, you need to put in place that serious level of MI that you would have once you are outsourced so that you do have this proper comparison.

**Mike:** Companies need to start with a very clear understanding of what exactly it is that they are outsourcing so that there is no ambiguity in terms of the function and services that ultimately you are looking to get from a third party service provider. It is only when you have a clear definition of what the services are that you can then do some form of value assessment as to what it is that ultimately can be outsourced and the value that may be gained from that.

It should also not be thought of purely from a financial perspective as clearly activities ultimately are outsourced because it is more efficient and cost effective to do so. There is however an ongoing cost associated with the provision of services on an outsourced basis but it is also about thinking for example, say in the fund accounting space, what the costs might be to keep systems up to date, and to continue to train and develop your employees over a period of time. This is value that can be banked because you no longer in effect need to consider upgrading core technology or training and developing staff when in reality you have handed over the associated activity to a third party provider.

You shouldn’t lose sight of the fact that oversight in particular will be required in regulated industries like asset management where quite clearly the responsibility for what an outsourced provider does absolutely lies with the asset manager. You need to make sure that when you are creating a business case that you take into consideration what costs you will incur from establishing an appropriate oversight framework and regime. There are a number of different elements that need to go into the business case to ensure that you’ve captured the true value of outsourcing the component part of the business which may or may not seem evident from the outset. It is ensuring that you think holistically about the services that you are trying to outsource.

In identifying costs you need to consider not only basic salary costs, but total compensation so there will be additional costs that you will need to think about for services that are done by employees in-house which then have to compare with the costs that you pay third party service providers.

**Jamie:** Is it possible for these metrics to be obtained in house or is a de facto third party advisory required?

**Melanie:** I was a consultant for ten years and there are different ways of looking at this. For benchmarking your own services against the market there are some services out there but they aren’t cheap. However they can give you a good indication of
where you are at against outsources providers or other organisations who are keeping things in-house. Equally, getting advice about what to measure early in the process, as you might be starting to think that this could be a strategy is helpful. I’m not suggesting that you go to the same level of MI or SLA as you would once you have outsourced as that is a different kind of contractual relationship, but I do feel that identifying a few of the key things that are important to you and making sure that those metrics are there is important. They may well be there already but you need to look at it across all the things that you might be outsourcing. If trade figures are coming through in your business regardless, you might find that some of the other aspects of outsourcing may be around speed of asset set up which aren’t necessarily being measured and potentially getting a bit of help in to put in place the basics can improve this. It will also save you time when you outsource as you will have something to build from and you’ll have some understanding of what is important to you and what you’ll need to know.

Mike: We did our lift-out of fund accounting and middle office back in 2003 and we did use third party advisors who helped us build the business case and model in terms of understanding the commercial aspects of the outsource initiative and helped us to establish the service definition document which we wrapped around the provision of services from the third party. In 2005 we were very much able to utilise the template that had been left with us from the original fund accountant and middle office outsource and apply it to a transfer agency outsource that we did. Over the last nine years we have become more self-sufficient in terms of our ability to enter into material outsource arrangements on our own behalf. We are less reliant on third party providers though we may, from time to time, when we are looking to procure services, may seek some fresh input from advisors and also to help with some of the due diligence to ensure that what we are buying is totally understood.

“Companies need to start with a very clear understanding of what exactly it is that they are outsourcing so that there is no ambiguity”

Mike: We are an asset manager and clearly we have grown significantly over the last 16 years since Standard Life Investments was launched as a stand-alone asset manager within the Standard Life Group of companies. In 2003 we started to think more globally about our business and we had also seen continued growth in the business which made us think about the back office requirements of a global asset manager. We concluded that these were very different from when we started out as a UK based asset manager. Hence the services that we needed to provide from a valuation perspective as well as the settlement activity from the middle office perspective started to become different. Ultimately we were looking to have to hire a greater number of people in the fund accounting space and that challenged us to think about what our core competencies were in the asset management company, this was clearly fund management and the ability to service clients and ensure that the clients are getting what they need. Our core competence is also in understanding fund accounting and middle office services but the outside world with many of the large U.S banks and other global financial institutions starting to provide fund accounting and middle office services meant that there was an option there.

As you move from being a relatively small through to medium to large asset manager you do start to think about what is core to your business and the more that you start to diversify your product set to move away from single region to a more global basis, it does
Taking the first step – what key parameters must be considered when designing outsourcing initiatives?

lead you to question whether you should be continuing to do certain activities and whether they genuinely remain core. This is how we got to our evolution within the business

**Jamie:** What measures would companies need to implement to ensure their outsourcing programmes are sustainable and can evolve with the needs of the business?

**Melanie:** It is a challenge and in a selection you need to pick somebody with a culture of developing on their own account rather than just being client reactive. If you have an organisation that is trying to look for the next trend and develop for this trend then although what they develop may not be perfect for you and you may need to tweak it, they will have a mind-set to be moving their product forward.

Anything that you’ve got that you know about now, you need to build those strategic requirements into your plans, timelines and make sure that you’ve got commitment to support with those.

A lot of the contracts these days have a pre-paid element of change within the contract so you get so many days of support. You need to make sure that you’ve got a sufficient amount of support to be able to do plenty of change, and with a lot of the organisations you also need to ensure that you’ve your own road map for change, so that you are making change every year yourself and that your own road map is consistent. By expressing this clearly it builds into the supplier expectations that you are going to change things. Doing nothing for two years after the outsource because of fatigue and then suddenly wanting to do a whole load of change in year three is not going to go as well as you would hope.

You can also consider using multiple parties in different time frames. The idea of handing everything to one party is in some ways convenient but not always straightforward in terms of some of the oversight issues that are out there at the moment. It can be helpful to have more than one partner but equally in terms of making sure that you have people who are focused on developing their business in certain areas. Connectivity and managing these relationships is a skill that you will have to build but it is feasible. And actually if you have multiple parties, although getting change to happen sometimes be a little bit more complicated, you have more opportunity to continue building your business out because there is multiple organisations building different parts of it and you aren’t overburdening one organisation.

**Jamie:** Yes that is quite a key attribute for the multi outsourcing model when you get back to looking at the evolution aspect of the business aspect, if you are tied down to that one provider than you are just as tied to their ability to evolve and I guess the opportunity to remain agile and deal with different changes at different times is much enhanced by working with multiple providers. At some point you have got that service integration and management layer that you need to take a stand on who is going to be operating and running that. What are your thoughts on that layer to keep your business agile and flexible?

**Melanie:** You have to accept the overhead of that and it may well not be a skill set that you have in-house and is something that you may need to bring in. Whether you bring that in on your own books or whether you look to partner with somebody to do some of this with you will obviously depend on your own culture and way of doing things but it is a critical piece and if you don’t invest enough in that then the multi supplier isn’t going to work.

**Mike:** Post the global financial crisis there has been a sharp focus on ensuring that you don’t have all your eggs in one basket. From a risk perspective it doesn’t make sense to have a business be completely reliant to a single service provider. With a small number of providers there is the ability to introduce some competitive tension between the respective providers and there is also the ability for us as the asset manager to try and identify between the providers that we deal with what we would deem to be best practice and ultimately try to share and learn from at least two providers so that we do have a more considered view around, for example, the interpretation of new regulation, or what would deem to be an effective control environment.

There is a genuine opportunity with multiple providers to really establish what is best-practice rather than to simply default out a single way of doing things as that just how your provider has chosen to interpret a new piece of regulation or market practice.

**Jamie:** Are there any areas you would advise growing companies to keep in-house, and what risks would that entail?

**Melanie:** It depends what model you’ve gone for as if you have gone for the multi specialist then it might be easier to outsource a lot of things. If you have gone with the factory approach and gone for one of the big players then you have to look at your business and decide that this is either factory now like trade confirms, or similar, and it can just go out, or you are prepared to change some or all of your business and have standardisation.

If this isn't something that you are comfortable with, be it client reporting or something else where you feel it is a USP to be bespoke and be able to react quickly then it comes back to the point I made earlier where you have to think very carefully about outsourcing or your outsourcing model before you put those out. These are the activities that you need to keep close to you because with all the will in the world
Taking the first step – what key parameters must be considered when designing outsourcing initiatives?

the providers have multiple people to service and they aren’t going to move as fast as you would like them to.

**Mike:** We considered a number of services that we decided to retain in-house; one was client reporting, and the other is performance measurement. The reason for this is that we feel there is value add in the performance measurement function residing within the asset management business to be close to the fund manager to be able to have conversations about the types of services that asset managers would like to see from a performance and attribution perspective.

For the client reporting again it is that interaction in terms of the provision of information to the clients which is really important in terms of getting any feedback directly into the asset management company about what is clearly contained within the client reports. We have tried to build both the client reporting and the performance measurement functions into our oversight regime for the provision of data from our third party service providers. Performance measurement is a massive consumer of the investment data that has come in from our third party service provider and so what we have been able to do is potentially identify any issues with the quality of that investment data coming from our third party provider in our performance measurement function. We have basically built our performance team into our oversight regime of our third party service provider rather than simply putting those services out.

The risks associated with the retention of both of those functions come back to not being so much a risk. Rather, what you have done by default, is in effect made a commitment that you will continue to invest in technology, systems, processes and people in those respective disciplines. There is a risk that you will not always be able to find a supply of suitability qualified people in order to be able to fulfil those roles and if this became an issue or the costs to invest in those areas became prohibitive then we would look to once every two years to formally review our decision to retain these two functions in house. It is not about making a decision and then forgetting about it for a five or ten year period, it is something that needs to be constantly reviewed. One of the key things that operations functions of asset managers have to do is make sure that the activity that is done in house is genuine value add to the overall business.

**Jamie:** I suppose if that is the core blood of your business then if you are even outsourcing that then the question is what are you doing in the first place?

**Melanie:** Yes and you can bring yourself right down to just managing the money or designing the product and that is perfectly fair, but you have to be cognizant of having some fairly standard process behind that or bring in a model where you have multiple specialists. The risk of the multiple specialist and keeping things in-house is at the level of operational knowledge particularly if you keep small pockets. Obviously you need to understand operations to a good extent to be able to manage an outsource relationship but you may be increasing costs as you have I.T systems, and that is a very small piece of the business, that you are keeping in-house and so you need to think carefully about the costs and people risks as you have smaller teams.

I feel that people don’t start thinking about this soon enough in considering what it is that they are trying to achieve and what they want. They tend to come up with a quick strategy and selection and try to have it done as fast as possible and actually this is something that people need to move towards over a number of years rather than something they can do in five minutes flat.

**Jamie:** Thank you for taking the time to share your thoughts on this topic.
What practical elements must be considered when planning exit programmes?
What practical elements must be considered when planning exit programmes?

Moderator

Jenna Gadhavi: As the needs of the business change certain functions may be better serviced internally but what are the inherent risks in moving away from your current outsourcing provider?

Keith Waudby: Organisations should have a register of services being delivered by individual providers and ensure that they understand and ‘know their service providers’. The inherent risks of moving away from a service provider depend on whether an organisation has: access to data, relevant systems or even other providers i.e. other providers in the market who can provide this service. Organisations also need to ensure that they have sufficient in-house skills and resources to cover key activities that would be brought back in-house.

Any customisations that are unique to your firm’s or clients’ needs would also increase the risk and the costs associated with any move.

Hermes certainly has the necessary in-house skill set to provide governance and oversight of our providers. The question would be whether we had sufficient resources in house to actually perform those functions if they were brought back in-house.

Maria Khan: Its worth considering how your risk profile changes in moving services away from an outsource provider. For example, with an outsourcing arrangement any errors made are rectified by the provider and the compensation aspects fall to them, as opposed to having to be picked up by the company itself. As Keith mentions, ensuring that an adequate skill set is retained in-house is also key.

Jenna: How do you ensure that the business continues to function without any loss of continuity or quality whilst transferring from different providers?

Keith: Knowing what is outsourced and which services are supported by your provider is key. The way Hermes categorises outsource providers is in terms of what they do on our behalf e.g. is it a regulated activity or an activity that is material to the business and also in terms of: if an event happens which causes a disruption to the service, what the impact would be etc.

In terms of exit planning you need to consider two scenarios; one which is a planned exit (which can be run as a project, in an orderly manner) versus an emergency exit (where a party has gone into administration for example). It is key to have a plan and identify which steps can be carried out concurrently, which steps are a priority and the overall sequence of events based on the implications of not having that provider or data.

You need to consider the ease of transfer and how difficult it would be to switch either to an internal function or an alternate provider. This is where having a clear outline of what the outsource/service provider is doing on your behalf and the implications of not having that service provider in place.

It is also important to consider the impacts to clients and organisations should have a planned communication in place to ensure that clients, regulators and other stakeholders are informed. It is equally important to identify whether you would have a skills gap or where you would need to bring in extra resources to perform certain functions whilst transitioning to different providers. Estimating the time frames for different exits and the impacts on the business is also key. The way we typically do this at Hermes is to break down the functions that are being carried out by that provider and assume that one function or a series of those functions are not available for different time frames. We then estimate the different impacts and risks that would arise.

Maria: In a planned exit there are a number of measures that you could undertake to minimise the impact of the transfer. Managing an emergency exit is very different and in reality it is unlikely that such a situation can be managed without any loss of continuity or loss of quality. Exit plans should consider emergency events and detail how the disruption from these can be minimised.

Jenna: What due diligence would you recommend to be conducted on new prospective outsourcing partners?

Keith: The due diligence that we conduct when assessing outsource providers is wider than just the services that they are going to provide. While you absolutely need to understand those, you equally need to have a view of the wider organisation. Continual due diligence should also be undertaken and due diligence should not be a one off activity, it is an ongoing piece.
It is important to understand the governance structure and controls that would be in place at the provider, their BCP plans and sub delegations; whether there are any activities being done by a separate third party or whether activities are off-shored. At Hermes we look at the materiality of the activity. Where activities are deemed material and are off-shored, we would potentially go and visit those locations with site visits. You need to also consider the staff that the provider has, the training that they receive and the credit worthiness of that provider. Other things to consider is what systems the provider uses (are they off the shelf or bespoke/ in-house built), are there key person dependencies etc. In relation to governance and controls, you would need to understand what errors, compensation rates and insurance premiums have been recorded over a sufficient time period, where that information is available.

**Jenna:** Are there any case examples you can give as to how you managed your own exit strategy and what you have learnt from that?

**Keith:** We have been in a position where we have outsourced some of our activities for a number of years but we haven’t had to go through a change of provider in an emergency situation. The only examples we can run through is where service deliveries have been compromised in the short term, where we had planned a migration of activities and on the go live date there were certain functions that were not available because of IT system issues with the provider. We had planned for such eventualities as part of the migration and we had a manual work around in place to cover that activity. There were some manual activities which would typically have been electronic communications, which had to be done manually. We also ensured that the necessary controls were in place to mitigate the risks relating to manual work-arounds.

**Jenna:** Can you suggest any best practice, risk management procedures to help any who are currently working on their own exit programmes?

**Keith:** You have to take a risk based approach and you need to consider the impacts. You need to identify the priorities of your business and client base. There are inherent risks which we would look to mitigate and consider what would happen in the event of a partial, full failure or exit.

**Maria:** We use our internal risk methodology on our outsource providers (utilising inherent and residual risk scores based on an assessment of the impact and probabilities of risks crystallising), so we would have a risk assessment in place for all of our material outsource providers. This then feeds into exit planning and impact analysis, which inform us as to: 1) which areas have the highest impact and 2) where the controls are the most important and are mitigating the highest risks. We would then focus our oversight and exit planning on the highest impact areas and key controls. The risk management methodologies that asset managers have in place should be extended to cover outsource providers, as outsourced functions should be viewed as an extension of a company’s internal operations.

**Keith:** The whole thought process behind risk mitigation and exit planning is not a one off exercise but an ongoing process that you need to consider throughout the whole time that you have an outsourced service as you need to identify anything that is new or changing with your provider so that you know exactly what they are doing on your behalf.

**Other key points to consider when exit planning:**

- Firms should have an exit plan in place that is comprehensive enough to be executed ‘in anger’, as well as one that can be used under a planned transition.
- Exit plans should contemplate 3 “parties” – the existing supplier, new supplier and asset manager.
- Plans should consider: people, systems, timings, step-by-step transitions of key activities, what services could be provided in house from day one etc.
- Plans should have input from existing providers.
- Plans should consider the client perspective (e.g. how quickly will investors get their money back, what would they expect to have on day one etc).
- Firms should give some consideration to which providers services would ideally be transferred to.
- In negotiating contracts, firms should consider the inclusion of more detailed exit plans.

**Jenna:** Thank you for sharing your insight into this topic.
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